Harcourt Brown & Carey
ENERGY & FINANCE

CLEAN ENERGY FINANCE PROGRAMS:

Assessing Program Risk and Addressing the Holder Rule

An overview brief presented by Harcourt Brown & Carey (HB&C)

As builders and designers of clean energy finance programs, we at HB&C work with a broad range of energy industry clients, including energy associations, utilities, state, local and federal government agencies and finance industry clients including, banks, credit unions and finance companies (collectively "lenders") and capital providers. Much of our work involves the integration of the energy and finance industries to create clean energy finance programs. Often, our work involves explaining how to safeguard against risk exposure associated with these programs. Below, HB&C summarizes such risks, points out key considerations and discusses how best to evaluate and address them.

What are the risks and who faces them?

Risks for clean energy finance programs can range from headline risk (unfavorable media coverage of a problem) to reputational risk (consumer dissatisfaction) to liability risk, which includes both legal and regulatory risks including fines, business restrictions and voided contracts. Who faces these risks is generally determined by what program role is undertaken by our energy and finance industry clients.

The majority of clean energy financing programs usually involve three key roles and parties:

LENDERS

They can include community development financial institutions, credit unions, banks and finance companies. Meanwhile, the term "loans" can vary in practice from a direct loan transaction between a lender and borrower to a Retail Installment Contract, (RIC). The latter is a finance contract, typically between a consumer and contractor for payment of goods and services. Contractors then assign their RICs (along with the accompanying debt obligation from the borrower) to lenders to obtain their payment. In both cases, "loans" with consumers are considered "consumer credit contracts," subject to myriad federal and state regulations.

CAPITAL PROVIDERS

The capital that Lenders use to provide funding for financing programs can include:

a) Internal lender capital facilities, in which the lenders keep loans "on their books," holding them through maturity. An example is credit unions using member deposits to facilitate loans.

b) Third party-credit facilities with capital providers in which the lender originates and assigns, or grants, a security interest in loans. The capital provider is entitled to the cash flow from loans, typically contracting the lender for continued servicing of the loans.

c) Securitization where loans are "pooled" together, selling their related cash flows to third party investors as securities. An example of a security is an investment grade "green bond."

PROGRAM SPONSORS

Their role is to connect lenders and capital with other program elements such as contractor networks, rebates and marketing. Examples could include:

d) A utility sponsors a financing product to support its demand-side management program and develops program elements such as eligibility of financed measures, customer target segments and contractor management.

e) A state energy office provides loss-reserve capital to make loans more affordable to constituents across the state.

f) A local, state or federal government provides capital for a loan program, such as a revolving loan fund.

Lender and Capital Provider Risk and Liability

When lenders get involved with contractors to finance the sale of consumer goods, these lenders may be subject to claims and defenses that consumers have against contractors.

With most consumer transactions, risk and liability follow the money. For example, when a homeowner purchases a new furnace, the contractor installs a furnace based on a contract for goods and services and the money flows from the homeowner to the contractor. If something goes wrong with the furnace, the consumer may withhold payment or assert a legal claim and defense, and the contractor may be held liable for damages under that contract.

But, when lenders get involved with contractors to finance the sale of consumer goods, these lenders may be subject to claims and defenses that consumers have against contractors, up to the amount of payments the consumer has made. Whether or not a lender is subject to claims and defenses depends on the existence and nature of the relationship between the contractor and lender. The following scenarios describe instances in which a lender may or may not be subject to claims that would otherwise have been made against the contractor.

The FTC Holder Rule protects consumers who enter into credit contracts with a seller of goods or services by preserving the consumer's right to assert claims and defenses against any holder of the contract.

When the contractor has no relationship with the lender, the lender is not liable. Here's an example:

> *A homeowner enters into a transaction with a contractor to purchase a new furnace with a credit card or a personal loan from a local credit union. In this case, the contractor may not even be aware that financing was used in the transaction. The contractor has no business relationship with a lender involved in this transaction.*

However, should an established pattern of referrals or business relationships between the lender and contractor exist, liability may extend to the lender and capital providers. The integration of the energy and finance industries to promote energy initiatives almost always gives rise to this type of relationship. To follow up with an example of when the lender may be liable, here is another example:

> *Using the furnace example, if something goes wrong, the contractor is liable; however, lenders and capital providers who hold the consumer credit contracts ("holders") may be subject to the Holder Rule. "Holders" may be the original lender, or third-party purchasers or assignees of consumer credit contracts.*

THE HOLDER RULE EXPLAINED

The Federal Trade Commission's (FTC) Holder Rule[1] protects consumers who enter into credit contracts with a seller of goods or services by preserving the consumer's right to assert claims and defenses against any holder of the contract, even if the original seller subsequently assigns the contract to a third-party creditor. In particular, the Holder Rule requires sellers that arrange for or offer credit to finance consumers' purchases to include in their credit contracts the following notice:

[1] The Holder Rule is defined by the Federal Trade Commission's (FTC) Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433. https://www.fdic.gov/regulations/compliance/manual/7/VII-2.1.pdf

Sellers that arrange for or offer credit to finance consumers' purchases must include a notice in their credit contracts.

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED [PURSUANT HERETO OR] WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

The National Consumer Law Center (NCLC), a non-profit organization advocating consumer protection in energy policy, offered the following comments explaining the importance of the Holder Rule to the California Public Utility Commission (CPUC) in connection with the development of statewide energy efficiency finance programs:

> *In consumer credit transactions, one of the most important issues is whether a creditor is subject to the claims and defenses that the consumer has against the seller or originator creditor. The liability of subsequent creditors for the acts of the original creditor/seller is important for two reasons. First, the seller or original creditor may be judgment proof, so that consumers would be left without a remedy if they had to pay the holder of the note and then try to recover all or some of this amount from the original seller or creditor. Second, even if the seller is solvent, it is usually impractical to expect a consumer to defend a collection action (or utility shutoff process) and simultaneously bring an affirmative suit against the seller or original creditor.* [2]

More recently, the NCLC and a consortium of consumer advocacy organizations provided comments to the FTC in connection with its 2016 review of the Holder Rule, providing a more current restatement of its importance with consumer protection and financing.[3] Also in 2016, NCLC submitted comments to DOE in connection with "Best Practice Guidelines for Residential PACE Financing," advocating that PACE financing, which operates as a tax assessment outside of consumer protection laws, should be subject to such laws including the Holder Rule.[4]

[2] http://www.nclc.org/images/pdf/energy_utility_telecom/on_bill_financing/nclc_comments_in_ca_%20r0911014_24feb2012.pdf

[3] https://www.nclc.org/images/pdf/car_sales/comments-ftc-holder-2016.pdf

HB&C believes that the CFPB may seek expansive enforcement of the Holder Rule.

Enforcement of the Holder Rule is expanding. The Consumer Finance Protection Bureau (CFPB), a government agency created after the 2008 financial crisis to protect consumers in finance transactions was authorized to enforce numerous consumer finance protection rules and orders from several agencies, including the FTC and its Holder Rule.[5] HB&C believes that historical limitations on FTC jurisdictional authority, that exempted FTC enforcement of the Holder Rule on depository institutions (banks and credit unions) do not apply to the CFPB and that the CFPB may seek expansive enforcement of the Holder Rule. Thus, HB&C believes that all "lenders" cited above could become subject to the Holder Rule where any direct or perhaps indirect association or affiliation exists between lenders and contractors. This may also subject any subsequent "holder" (capital provider) of a consumer credit contract to the same risk and liability.

HB&C recognizes that there are limitations, exemptions, and interpretive arguments to the applicability of the Holder Rule that may be undertaken by lenders. However, we believe that the underlying tenet and benefit of the Holder Rule—that contractors should be "policed" to protect consumers from their misconduct in financed transactions-—is of paramount importance to consumers, as well as to lenders, capital providers and program sponsors.

Program Sponsor Risks and Liability

Program sponsors engage in a relationship that leads to an association between the sponsor, lender(s) and contractor(s). Most assume a headline risk; and, if they are providing capital into the program, they may be exposed to legal risk and regulatory sanctions as well. Following is an example:

> **ABC Utility Company** *has provided a loan loss reserve for a financing product provided by* **lender X** *and promoted the product through its own contractor network. As a result, some of those contractors have gone through* **lender X***'s vetting*

[4] http://www.nclc.org/images/pdf/energy_utility_telecom/on_bill_financing/comments-doe-pacef-aug2016.pdf

[5] https://www.gpo.gov/fdsys/pkg/FR-2011-07-21/pdf/2011-18426.pdf

If the program sponsor chooses to provide capital for consumer credit contracts (e.g., a revolving loan fund), it may find itself in the position of a lender and/or a holder.

process and have become part of its loan dealer/contractor network. One of the contractors, **Z Plumbing and Heating***, installed a faulty furnace and the homeowner is now asserting a claim or defense against the lender.*

While it has no exposure to the Holder rule, because it is not the lender or holder of the consumer credit contract, the impact to ABC Utility Company is twofold: if a loss generated through a claim or defense is covered by a loss reserve agreement, ABC Utility Company could be required to cover losses based on its loss reserve structure. If the loss reserve doesn't cover losses incurred by claim or defense, then headline and reputational risks still may be encountered.

The headline and reputational risks are already issues that most program sponsors encounter. Program sponsors typically communicate non-affiliation disclaimers to consumers, along with their lists of participating contractors.

However, if the program sponsor chooses to provide capital for consumer credit contracts (e.g., a revolving loan fund), it may find itself in the position of a lender and/or a holder.

Program sponsors should consider two important points:

1) Notwithstanding disclaimers, consumers will still trust and rely upon even "implicit endorsements" by program sponsors. When contractors associated with program sponsors pitch energy efficiency improvements to consumers, those consumers may rely upon the program sponsor to ensure that their purchase and financing is economically beneficial and competitive with other options. When the program sponsor is a government entity, the consumers' reliance on the program sponsor becomes more important.

2) Contractors value participation in energy finance programs because it lends them credibility and distinction in their sales pitches. However, the potential for contractor misconduct can expand to include misrepresentations of the contractor's association with the program sponsor (e.g., an "agent" of the program sponsor presenting a limited or exclusive offer), energy savings

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misrepresentations (e.g., overstating economic benefits). Worst-case scenarios may involve contractors exploiting program participation and manipulating consumers to accept over-priced goods. This scenario is important for consumers who do not shop for multiple contractor bids, particularly for elderly consumers and other protected classes.

Limiting Risk Exposure

HOW LENDERS AND CAPITAL PROVIDERS CAN LIMIT RISK EXPOSURE

Reputable lenders in the home improvement industry understand the importance of ensuring contractor quality control through background checks, licensing reviews, consumer feedback and enforcing disciplinary action against deficient contractors. In fact, a robust contractor quality control and vetting process should be considered one of the hallmarks of a reputable home improvement lender.

Therefore, before a capital provider purchases a loan from a lender, it should determine whether the Holder Rule applies. Additionally, it should conduct due diligence on the lender's contractor quality assurance procedures, if they are present, to protect its own liability under the Holder Rule. Similarly, when a program sponsor engages with a lender, it should also undertake due diligence. Both parties should consider how to address contractor misconduct that is unique to energy finance programs (such as over-stating of energy savings and exploitation of association with the sponsor.)

How Program Sponsors Can Limit Risk Exposure

Program sponsors should keep in mind the following points when understanding their risks:

- Program sponsors should be aware of these consumer protections and issues so they can determine whether their prospective financing partners have the proper safeguards in place.
- Although headline risk can never be completely eliminated, ensuring that clean energy financing programs have strong consumer protection and contractor risk management features can help reduce this risk.
- In the case of facilitating lenders and their capital sources, program sponsors should be wary if they become a holder.
- Program sponsors should address any potential for contractor misconduct that arises due to their participation in an energy finance program. When a program sponsor engages with a lender, it should also undertake due diligence on the lender's management of Holder Rule risk.

To protect their own liability, capital providers and program sponsors should conduct due diligence on a lender's contractor quality assurance procedures.

Lenders generally maintain robust procedures to protect themselves against contractor risk in response to the Holder Rule. Ensuring that any chosen lender or capital provider provides dedicated contractor quality control and assurance is essential to mitigating risk. While these efforts may add to costs and workload, they are important for minimizing risk. These efforts should include:

- Avoiding misconduct and controlling representations made by contractors.
- Requiring that contractors distribute consumer program disclosures and that consumers confirm they receive the disclosures.
- Strongly encouraging consumers to get multiple bids (shop for the best price).

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- Requiring that the lender make a quality control call (verifying consumer satisfaction with the installation and guarding against misrepresentations and exploitation discussed above) prior to the creation of a debt obligation by the consumer.
  - » Requiring participating contractors to go through a vetting process, including background checks, licensing reviews and pledges to adhere to codes of conduct and industry standards;
  - » Requiring lenders to go through licensing reviews;
  - » Seeking regular customer feedback and providing dispute resolution;
  - » Annual or bi-annual review of all participating contractor licensing and background checks to ensure currency; and
  - » Imposing disciplinary action against deficient contractors.

In Conclusion

Many energy lending programs effectively manage risks, both from the program sponsor side as well as from the lending side. Effective risk management, including strong contractor QA/QC procedures, not only mitigates the risks discussed in this brief, but also contributes to a more effective and consumer protective program overall. As the industry leader in bringing the worlds of finance and clean energy together, HB&C has advised many clean energy finance programs on appropriate policies and procedures to mitigate the types of risks identified in this brief. We are well-versed on the risks and benefits of such programs and how to best structure them to ensure compliance and protection for all parties. Give us a call to discuss your clean energy finance program, or visit us at www.harcourtbrown.com.